

**METHOD OF SECURITIZING A PORTFOLIO
OF AT LEAST 30% DISTRESSED COMMERCIAL LOANS**

CROSS REFERENCE TO RELATED APPLICATIONS

This application claims priority of U.S. patent application serial no. 60/334,344, filed on November 29, 2001, hereby incorporated by reference.

BACKGROUND OF THE INVENTION

1. Field of the Invention

[0001] The present invention relates generally to asset securitization and, more particularly, to a system and method for use in securitizing a portfolio of at least 30% (and up to 100%) distressed commercial credit facilities, such that all of the securities above the equity or equity-like tranches issued by a bankruptcy-remote special purpose entity to finance the acquisition of the portfolio of distressed commercial credit facilities are eligible to receive investment grade ratings.

2. Description of the Prior Art

[0002] A credit facility is considered “distressed” if the borrower’s financial ability to honor its obligations comes into question. Common indicators that a borrower (or group of related borrowers, hereafter referred to collectively as the “borrower”) may have financial difficulty in repaying its debt include a breach of financial covenants, a payment or technical default of other debt obligations, or a trading value for the borrower’s debt significantly lower than other debt with similar coupon and maturity features. Not all distressed credit facilities are in default (e.g., as recognized by Standard & Poor’s (“S&P”), a company may be current on its bank loan obligations while being in technical or financial default on its other subordinated debt, resulting in significant near-term risk that the borrower will ultimately default on its obligations) (Albulescu, Henry, Bergman, Sten, and Leung, Corwin, “Distressed Debt CDOs: Spinning Straw Into Gold,” S&P Structured Finance, May 7, 2001, hereafter, “Spinning Straw Into Gold”). As used herein, “distressed credit facilities” and “distressed loans” are those commercial loans in which there has been a default by a borrower to make a payment or payments to a lender and/or a likelihood of a default has been identified by a lender in connection with the borrower’s obligation to make a payment to the lender.

[0003] Distressed loans are known to be subject to increased monitoring and may be subject to special accounting treatment. If a lender is a bank or other regulated entity, such distressed assets may subject the lender to increased capital requirements and regulatory scrutiny.

[0004] Lenders previously have had a limited number of alternatives for dealing with distressed credit facilities. One alternative is for the lender to continue to hold its distressed credit facilities. This option, however, imposes a number of additional costs on the lender. For example, a lender who retains distressed assets may need to employ specialized personnel and/or commit other management resources to manage and handle work-outs of the distressed loans, and establish appropriate reserves for loss contingencies. The process of working with problem borrowers to recover on distressed credit facilities is time-intensive and requires special skills and resources of a lender,

often not readily or plentifully available to the lender on a cost-effective basis. If the lender is a bank or similarly regulated entity, the lender may need to establish reserves to ensure the lender's compliance with applicable regulatory requirements. Retaining distressed assets may further risk giving interested third parties, such as regulators, stockholders and financial analysts, a negative perception of the lender's portfolio quality and management acumen, and may expose the lender to potential further loss if a distressed borrower's creditworthiness continues to deteriorate. In addition, in the case of revolving loans where a lender has approved a line-of-credit for a borrower, the lender may have a contingent obligation to lend additional monies to an already faltering borrower.

[0005] Another alternative traditionally available to the lender is to sell a distressed credit facility to "vulture" investors at a cash price representing a significant discount to the outstanding principal. This alternative may eliminate applicable regulatory pressure on the lender caused by the presence of the distressed credit facility on the lender's financial statements and may also eliminate the lender's risk of future losses from the credit facility. However, it is a costly remedy because of the immediate and likely steep losses that the lender incurs as a result of the sale at a discount.

[0006] Traditionally, there has been little market for a "one-by-one" sale of distressed credit facilities; to the extent such a market has existed, it has been characterized by punitive pricing and illiquidity. Middle-market syndicated loans (*i.e.*, aggregate credit facilities of less than \$100 million, for example, with five or fewer lenders participating in any of the credit facilities) and single-lender facilities often can be sold only to predatory investors in bulk-loan sales at substantial discounts, again resulting in steep losses to the lender. Loan losses from such sales not only have obvious economic repercussions, but also generally have unfavorable effects on the financial institution from the perception of interested third parties (*e.g.*, regulators, investors and financial analysts) who may interpret the loan losses as an indication that the lender's assets generally are of poor quality and that the management of the lender is imprudent or

incompetent. As a result, lenders, hoping to minimize their losses, often resort to the liquidation of borrowers with distressed credit facilities at much reduced recoveries.

[0007] Each of these options has a number of significant disadvantages for a lender. Consequently, lenders historically have been forced to weigh distasteful alternatives with a goal of developing a strategy for handling distressed credit facilities that a lender believes to be the least onerous. Because virtually any portfolio of outstanding credit facilities is likely to include some distressed credit facilities, lenders almost invariably are required to devote substantial time and capital to developing and implementing acceptable strategies for handling their distressed credit facilities.

[0008] Securitization of distressed credit facilities has previously generally been unavailable as an alternative for lenders. In a traditional securitization of commercial or corporate credit facilities and/or high yield loans, a portfolio of generally performing credit facilities, characterized generally by regular cash flows and predictable recoveries, is sold by a lender or lenders to a bankruptcy-remote special purpose entity (an "SPE," *e.g.*, a bankruptcy-remote special purpose trust, corporation or limited liability company) that finances the purchase by issuing asset-backed securities, (*e.g.*, notes or bonds) and equity and/or equity-like securities to its investors. "Bankruptcy remote", as used herein, has the meaning common in securitization transactions of an entity which, due to governance provisions in its organizational documents, agreements with equity owners and creditors, or other measures, is less likely to be subject to a petition in bankruptcy than a normal operating company. The underlying pool of generally performing credit facilities is used to secure or collateralize the asset-backed securities issued to investors in the SPE and/or to the lender or lenders from whom the credit facility pool is acquired. Heretofore, securitizations of commercial credit facilities or high yield bonds have been comprised principally of relatively high quality collateral with predictable and scheduled interest and principal payments, thus assuring predictable and regular cash flows and recoveries. The asset-backed senior and mezzanine debt instruments issued by the SPE in a securitization of such commercial credit facilities or high yield bonds are known to have received investment grade ratings (*e.g.*, ratings of Baa2/BBB-, or better) from credit

rating agencies (e.g. S&P, Moody's Investor Services ("Moody's") and Fitch, Inc. ("Fitch")) based upon the predictable, regular stream of cash flows (*i.e.*, interim payments of interest and principal) and the predictable recoveries (*i.e.*, actual aggregate payouts of interest and principal) generated by the underlying debt asset pool, resulting in a high degree of certainty that the SPE can meet in a timely manner all of its debt service obligations, including principal and interest. The achievement of such investment grade ratings for the asset-backed senior and mezzanine debt securities issued by the SPE allows the SPE to finance the acquisition of the credit facility portfolio on a cost-effective basis (investment grade securities generally bearing a significantly lower interest rate than non-investment grade securities and generally being more easily sold in the marketplace).

[0009] On the other hand, portfolios which include, for example, 30% or more of distressed commercial credit facilities previously have been characterized by the unpredictability and irregularity of their cash flows (sometimes referred to as "lumpiness") and recoveries resulting from the low quality of the distressed debt assets comprising a substantial portion of (or all) the portfolio. Prior to the present invention, this unpredictability and irregularity of cash flows and recoveries has precluded lenders from securitizing such a portfolio of distressed credit facilities on a cost effective basis, because of the inability to obtain all investment grade ratings for the asset-backed debt securities issued above the equity or equity-like tranche or tranches and used to finance the acquisition of the distressed credit facility portfolio. As used herein, the phrases "equity or equity-like tranche or tranches," "equity or equity-like tranches," "equity or equity-like instruments," "equity or equity-like securities" or words to similar effect include, for example, non-investment grade payment-in-kind (PIK) securities, securities whose tax characterization is uncertain, securities without a capped return, and securities that have a yield that is not commensurate with having an investment grade rating. Without the ability to obtain investment grade ratings, it was impractical for a lender to securitize a portfolio of distressed commercial credit facilities because it would be too costly to support the interest cost of the asset-backed debt instruments issued in the

securitization above the equity or equity-like instruments issued (investment grade securities generally bearing a significantly lower interest rate than non-investment grade securities).

[0010] Credit rating agency ratings for asset-backed securities are determined based on various parameters including cash flow modeling of the proposed transaction, stressing defaults and their timing, recovery rates and their timing, and liquidity needs. However, while the fundamentals of the rating process remain the same, the analytical emphasis and the assumptions used for rating a portfolio of 30% or more distressed credit facilities differ in response to the specific characteristics of distressed debt. (See, "Spinning Straw Into Gold.") For example, a typical SPE involved in a securitization of performing commercial credit facilities is stressed by a credit rating agency based on defaults and their timing. However, for an SPE whose underlying assets include 30% or more of distressed commercial credit facilities, a substantial portion of the loans in the pool are either already defaulted or expected to default. Thus, stressing defaults as a principal focus would not properly demonstrate the likely performance of the portfolio. Rather, recoveries, which are the primary driver of performance in a portfolio of distressed commercial credit facilities, are also stressed with the level of stress depending upon the credit rating sought.

[0011] Prior to the present invention, there has not been a system and method to achieve all investment grade ratings for the asset-backed securities above the equity or equity-like instruments an SPE issues to its investors and/or the lender or lenders as part of the purchase price for the portfolio of distressed commercial credit facilities, and thus there has not been a system or method to achieve pricing for the securitization of a portfolio of 30% or more distressed credit facilities comparable to that of a securitization of a performing loan pool. Investment grade ratings for the asset-backed securities issued by a distressed debt SPE result in a low cost of capital for the SPE, which allows the SPE the time to achieve the necessary recoveries on the underlying distressed assets and allows for ease of placement of the SPE's asset-backed securities in the marketplace in a manner and at prices comparable to those of SPEs whose underlying assets are performing

commercial credit facilities or high yield bonds. Thus, there is a need for a method for securitizing a portfolio which includes, for example, at least 30% or more of distressed commercial credit facilities on an efficient cost-effective basis.

SUMMARY OF THE INVENTION

[0012] The present invention offers a platform and a securitization methodology that provides lenders with an opportunity to maximize the returns on their distressed commercial credit facilities and overcomes the obstacles that have historically precluded the securitization of distressed commercial credit facilities. The present invention is based upon an underlying portfolio of at least 30% (and up to 100%) distressed commercial credit facilities for securitization that emulates the predictability and regularity of the cash flow and recovery characteristics of a portfolio of performing credit facilities, thus eliminating crucial historical barriers to securitization of such credit facilities, such as the absence of predictable cash flows and recoveries. The methodology of the present invention takes a specified mix of distinct classifications of distressed credit facilities with specified characteristics in confluence with structural specifications for an SPE, such as specific reserves and safeguards, to create a synthetic asset class that emulates the cash flow and recovery characteristics of an SPE containing a portfolio (which may be of dissimilar size) of performing credit facilities. As such, the portfolio of distressed credit facilities is amenable to securitization and the issuance of asset-backed debt securities (above any equity or equity-like tranche or tranches of securities issued by the SPE) all of which are eligible to receive investment grade ratings.

[0013] According to one aspect of the present invention, an SPE purchases a portfolio of at least 30% (and up to 100%) of distressed commercial credit facilities from a lender for an aggregate purchase price comprised of (i) a cash purchase price comparable to what the lender would have received in a bulk sale into the marketplace, or realized on a net, discounted cash flow basis if the lender had retained the distressed credit facility portfolio and utilized its internal workout effort, and (ii) an additional investment grade asset or assets with a value on the date of purchase, for example, in the range of 10-15% of the

face amount of the aggregate funded amounts included in the distressed credit facility portfolio.

[0014] The benefits of the present invention to a lender include the improvement of important financial ratios monitored by credit rating agencies and financial analysts, such as the ratio of non-performing loans to assets, the ability to free up valuable economic and regulatory capital and the opportunity to outsource the time-intensive and resource-expensive workout effort. Given identical default and recovery parameters (*e.g.*, 50% of the loans will be in default of current interest payments within 18 months; those that have defaulted will not pay interest for two years; those that default will recover at best, for example, 60% of par (face) value; and those that do not default will recover, for example, 85% of par value), the methodology of the present invention provides a lender with a more cost-effective alternative than maintaining the distressed commercial credit facility portfolio on its balance sheet and utilizing its internal workout effort to manage and collect the loans.

[0015] The present invention also allows the lender to replace the distressed commercial credit facilities on its balance sheet with cash and investment grade assets with an aggregate value likely to be substantially greater than the amount the lender otherwise would have received in a “straight sale” for cash to a distressed asset investor or other third party. Furthermore, the methodology of the present invention also allows a lender to remove distressed commercial credit facilities from its balance sheet with the opportunity of receiving economic benefits likely greater than would be realized on a net discounted cash flow basis through internal workout efforts by the lender if the lender had retained the distressed assets.

BRIEF DESCRIPTION OF THE DRAWING

[0016] These and other advantages of the present invention will be understood with reference to the following specification and attached drawing wherein:

[0017] **FIG. 1** is a block diagram of a process for securitization of a portfolio with 30% or more distressed commercial credit facilities in accordance with the present invention.

[0018] **FIG. 2A** is a block diagram which illustrates the process of selecting credit facilities from a lender's portfolio to develop a tentative portfolio of credit facilities for securitization in accordance with the present invention.

[0019] **FIG. 2B** is a block diagram which illustrates the process of evaluating the credit facilities in the tentative portfolio to determine whether predetermined criteria are met relating to borrower diversity and concentration.

[0020] **FIG. 2C** is a block diagram which illustrates the process of further evaluating the credit facilities in the portfolio to further determine whether predetermined criteria are met relating to industry diversity.

[0021] **FIG. 2D** is a block diagram which illustrates the process of further evaluating the credit facilities in the current portfolio to determine whether the predetermined criteria are met relative to industry concentration.

[0022] **FIG. 3** is a block diagram illustrating the processing of loan documentation and development of a securitization model in accordance with the present invention.

[0023] **FIGS. 4 and 5** are block diagrams which illustrate exemplary loan documentation to be obtained by the collateral manager in connection with a securitization of at least 30% distressed commercial credit facilities in accordance with the present invention.

[0024] **FIG. 6** is an exemplary block diagram illustrating a database model for organizing borrower data for use with the present invention.

[0025] **FIGS. 7A-7C, 8 and 9** are exemplary block diagrams illustrating a database model for organizing loan information for use with the present invention.

[0026] **FIGS. 10A-10K** are exemplary block diagrams illustrating a database model for organizing borrower financial data for use with the present invention.

[0027] **FIG. 11** is an exemplary block diagram illustrating a database model for organizing general pricing parameter data for use with the present invention.

[0028] **FIGS. 12A and 12B** are block diagrams illustrating the process of determining valuation criteria in accordance with the present invention.

[0029] FIGS. 13A-13G are block diagrams illustrating the process of determining the collateral coverage and also illustrate a database model for organizing the collateral coverage data in accordance with the present invention.

[0030] FIGS. 14A-14D are block diagrams illustrating a database model for organizing the borrower's debt capacity data in accordance with the present invention.

[0031] FIGS. 15A-15I, 16A-16C are block diagrams illustrating an exemplary process for determining work out parameters in accordance with the present invention.

[0032] FIGS. 17A-17E illustrate exemplary due diligence reports for use with the present invention.

[0033] FIG. 18 is a block diagrams illustrating the process of constructing a rating model in accordance with the present invention.

[0034] FIG. 19 is a block diagram illustrating the process of preparing summary loan information in accordance with the present invention.

[0035] FIG. 20 is a block diagrams illustrating illustrating the process of evaluating whether the distressed credit facility meets basic performance criteria in accordance with the present invention.

[0036] FIGS. 21A-21D are block diagrams illustrating the process of constructing an SPE capital structure in accordance with the present invention.

[0037] FIG. 22 is an exemplary spreadsheet representation of the SPE capital structure in accordance with the present invention.

[0038] FIGS. 23A and 23B are block diagrams illustrating a process for specifying default/recovery scenarios in accordance with the present invention.

[0039] FIGS. 24A-24D are block diagrams illustrating a process for generating cash flows for the default/recovery scenario specified by the collateral manager in accordance with the present invention.

[0040] FIGS. 25-39 are block diagrams illustrating the process of providing cash flow waterfalls for the securitization of a portfolio of at least 30% distressed commercial credit facilities in accordance with the present invention.

DETAILED DESCRIPTION

OVERVIEW OF THE PROCESS

[0041] The methodology of the present invention includes: (1) a portfolio of performing (if any) and at least 30% distressed commercial credit facilities selected to meet predetermined borrower and industry diversity criteria; (2) a self-amortizing and static SPE; (3) a mechanism to fund any unfunded revolver commitments; (4) a methodology to provide additional liquidity to certain borrowers; (5) a model and structure that aggregates the anticipated cash flows and which facilitates the requisite credit rating agency stress tests premised upon multiple default and recovery assumptions; (6) a methodology for the determination of optimum levels of interest reserves that ensure the timely repayment of interest on the investment grade debt issued in connection with the securitization of the underlying portfolio of distressed credit facilities; and (7) a capital structure designed in classes (or “tranches”) and sized for receipt of investment grade ratings on all of its asset-backed debt components (above any equity or equity-like securities the SPE may issue).

[0042] A high-level overview of a method of developing a securitization model for portfolios with at least 30% distressed commercial credit facilities in accordance with the principles of the present invention is illustrated in **FIG. 1**. The following description, which is to be viewed as illustrative only, is premised upon a portfolio of credit facilities of a lender or lenders containing at least 30% (and up to 100%) distressed commercial credit facilities and upon establishing a capital structure or securitization within an SPE collateralized by the portfolio of credit facilities. These procedures are expected to be performed by the manager for the securitized portfolio (such managers may act as structuring consultants, administrators for the SPEs and collection agents for the credit facilities (referred to hereafter as the “collateral manager”)). The method of the present invention makes possible the securitization of such a portfolio of assets with highly unpredictable and irregular cash flow characteristics and highly unpredictable recoveries resulting in the issuance of one or more tranches of investment grade debt instruments to investors and the lender (in addition to the cash purchase price paid to the lender for the

distressed credit facility portfolio), notwithstanding the distressed state of the underlying collateral pool.

[0043] Initially, in accordance with the principles of the present invention, a tentative portfolio of at least 30% distressed commercial credit facilities is selected for sale by a lender or lenders in connection with a proposed securitization, as illustrated in step 100 in **FIG. 1** and as described in more detail below in connection with the illustrative example in **FIGS. 2A-2D**. Thereafter, appropriate due diligence information regarding the selected credit facilities in the initial, tentative portfolio is obtained by the collateral manager from the lender and stored in a database, for example, a collection of templates, one for each credit facility in the initial, tentative distressed asset portfolio in step 102, as described in more detail below in connection with the illustrative example in **FIGS. 3-11**. The data is selected based upon on analysis of applicable credit rating agency studies regarding cash flow and recovery statistics of senior secured commercial loans in a manner that provides the lender, the credit rating agencies and any insurers of the investment grade asset-backed securities issued in connection with the securitization, with the information commonly used in connection with pricing negotiations, and rating and underwriting criteria, respectively. This data allows credit rating agencies and insurers, if any, to evaluate the underlying credit facilities in the portfolio solely from that data and other information included in the database, thereby eliminating the need (and the related additional manpower, expense and time inefficiencies) for the credit rating agencies or insurers to review the loan documentation underlying each individual credit facility, to enable the credit rating agencies to “shadow rate” the credit facilities in the portfolio solely from the information contained in the database. Using this data, anticipated cash flows for the credit facilities in the portfolio are determined and aggregated, and a pricing mechanism is determined, as represented by step 104 in **FIG. 1**, and a securitization model or capital structure is developed in step 106. A detailed description of the aggregation process and the development of a securitization model is discussed below in connection with the illustrative example in **FIGS. 18-39**.

[0044] Various database or template models are suitable for use with the present invention, depending on various factors including the particular credit rating agency involved in the transaction. These database models may be implemented by way of various commonly available software platforms, such as Microsoft Office 2000.

SELECTION OF DISTRESSED COMMERCIAL CREDIT FACILITIES

[0045] FIGS. 2A-2D illustrate in greater detail the process of initial selection of distressed commercial credit facilities for securitization of a portfolio having at least 30% distressed commercial credit facilities by selecting the distressed commercial credit facilities in accordance with predetermined criteria as set forth below in accordance with the present invention. More particularly, the process begins with a review of a lender's aggregate portfolio 108 of distressed commercial credit facilities. In particular, initially a tentative portfolio 109 of distressed commercial credit facilities is selected by the lender in accordance with predetermined performance criteria (performing-1, performing-2, and impaired), as discussed below, and preliminary percentage allocations provided by the collateral manager to the lender. As used herein, (i) "performing-1" means a credit facility (A) in which the borrower is currently paying, and is anticipated to continue to pay current interest on amounts owed under the credit facility throughout the term of the credit facility, and (B) which is anticipated to have a par or near par (*i.e.*, at least 85% of face value) recovery of principal and accrued interest at maturity, (ii) "performing-2" means a credit facility (A) in which the borrower is paying current interest on amounts owed under the credit facility, but is anticipated as not likely to continue to pay current interest throughout the term of the credit facility, and (B) which is anticipated to have a less than near par (*i.e.*, in the range of 60-85% of face value) recovery of principal and accrued interest at maturity, and (iii) "impaired" means a credit facility in which the borrower is in default on an obligation to pay current interest.

[0046] The preliminary percentages of performing-1, performing-2 and impaired credit facilities are determined by the collateral manager on a case-by-case basis, but, for purposes of illustration only, may be assumed to be in the ranges of 35-40%, 40-45%, and 15-25%, respectively, of the aggregate principal balance of the portfolio. These

percentages are adjusted by the collateral manager in accordance with normal business practices (taking into account the timing and amount of estimated borrower payments and recoveries on collateral) to balance the distressed commercial credit facility portfolio in connection with the proposed securitization in order to create a synthetic cash flow stream that emulates the characteristics of a pool of dissimilar size of performing credit facilities (*e.g.*, there may be need for a larger number of distressed credit facilities in the pool than would otherwise be required if the pool consisted of performing credit facilities, in order to mirror the performance characteristics of a performing loan pool). For example, the greater the percentage of performing-1 credit facilities in the pool, the greater the corresponding percentage of impaired credit facilities that may be included.

[0047] The initial credit facilities selected by the lender are further screened in steps 110-118 in the illustrative example. These steps 110-118 are intended to further refine the selection of the distressed credit facilities included in the initial, tentative portfolio in a manner that ultimately will result in a portfolio that emulates the results of studies by credit rating agencies' such as S&P, Moody's, and Fitch, regarding anticipated cash flow characteristics and recoveries on senior secured commercial debt instruments. More particularly, the methodology of the present invention includes a system to gather data and price loans, and to model cash flows and loan performance in a manner satisfactory to the credit rating agencies and which meets their requirements to quantify risk within the context of various existing default studies (*e.g.*, Carty, Lea V. et al., "Bankrupt Loan Recoveries," A Moody's Special Comment, Moody's, June 1998; Carty, Lea V. and Hamilton, David T., "Debt Recoveries for Corporate Bankruptcies," A Moody's Special Comment, Moody's, June 1999; Van de Castle, Karen and Keisman, David, "Recovering Your Money: Insights Into Losses From Defaults," S&P CreditWeek, June 16, 1999; Hamilton, David T., "The Investment Performance of Bankrupt Corporate Debt Obligations: Moody's Bankrupt Bond Index 2000," A Moody's Special Comment, Moody's, February 2000; Brand, Les and Bahar, Reza, "Recoveries on Defaulted Bonds Tied to Seniority Rankings," A S&P Special Report: Ratings Performance 1999,

February 2000; Keisman, David and Yung, Ruth, "Suddenly Structure Mattered: Insights into Recoveries of Defaulted Debt," S&P CreditWeek, May 31, 2000).

[0048] The process is applied to each credit facility initially selected by the lender, and is designed to exclude credit facilities which, according to published credit rating agency studies, have poor historical principal recovery profiles and erratic cash flow characteristics, and whose inclusion would negatively affect the rating agencies' assessment of risk for the SPE. The process is based upon some or all of the exemplary criteria in accordance with the present invention, illustrated and described in connection with **FIGS. 2A-2D**. It should be noted that the criteria may vary as credit rating agencies update their studies or different credit rating agencies are chosen for the transaction.

[0049] More specifically, in the illustrative example, credit facilities in the lender's initial, tentative portfolio which, by the terms of their loan documentation, mature too late in the term of the proposed securitization are eliminated in step 110. This step serves to reduce the risk that the collateral manager will be left with insufficient time to recover on credit facilities on which the corresponding borrower defaults on one or more payments before those payments are renewed and needed by the collateral manager to fund and pay the securities issued by the SPE at their stated or credit-rated maturity. Next in step 112 in the illustrative example, unsecured credit facilities and credit facilities secured only by stock or other equity interests in the corresponding borrower's subsidiaries are eliminated. Moreover, in the illustrative example, credit facilities that are denominated in foreign currency and credit facilities extended to non-U.S. borrowers are subsequently eliminated in step 114, and credit facilities extended to borrowers whose debt is supported by no or minimal collateral and/or minimal restrictive covenants (sometimes referred to in lending parlance as "fallen angel borrowers" after their debt has become distressed) are eliminated in step 116. Subsequently in step 118, credit facilities extended to borrowers that are tainted by material accounting irregularities, significant environmental problems, protracted litigation, and the like are eliminated. After eliminating credit facilities from the initial, tentative portfolio 109 in steps 110, 112, 114,

116, and 118, a tentative portfolio 120 containing credit facilities eligible for securitization according to the present invention is assembled.

[0050] Referring to **FIG. 2B** in the illustrative example, the tentative portfolio 120 is used as a starting point for the “current” credit facility portfolio, as indicated in step 122, and further analyzed and manipulated as discussed below in connection with the illustrative example in **FIGS. 2B-2D** to ensure that credit facilities in the tentative portfolio 120 meet various diversification requirements. In particular, these procedures are intended to test if the tentative portfolio 120 meets, for example, S&P industry sector concentration limits and whether the tentative portfolio 120 is likely to have, for example, a Moody’s diversity score of at least 25. More particularly, in step 124, a determination is made of the borrower diversity and specifically whether the number of borrowers represented in the current credit facility portfolio 122 is greater than 30. If not, the current portfolio 122 is not likely to meet the criteria for diversity and, consequently, the proposed securitization of the current portfolio 122 is not performed unless the current portfolio 122 can be modified. More particularly, if it is determined that the number of borrowers represented in the current credit facility portfolio is not greater than 30, then a determination is made in step 126 whether the lender has other eligible credit facilities which can be included in the current portfolio 122 to increase the number of borrowers represented therein above 30. If there are other eligible credit facilities, then these other eligible credit facilities are added to the current portfolio in step 128 to meet the borrower diversity requirement.

[0051] Once the borrower diversity requirement is met for either the current portfolio 122 or the modified current portfolio, the portfolio is further processed in steps 130-134 in the illustrative example to determine loan commitment concentration for each borrower represented in the portfolio. More particularly, the percentage of the loan commitments to each borrower relative to the aggregate loan commitments to all borrowers under all credit facilities included in the current portfolio 122 or modified current portfolio is determined in step 130. Subsequently, a determination is made in step 132 whether the loan commitments to any borrower represent more than 5% of the aggregate loan

commitments to all borrowers under all credit facilities included in the portfolio, with the norm being in the range of, for example, 1.5-3%. If so, the current credit portfolio 122 or modified current portfolio is again rebalanced so that the loan commitments for any borrower represent no more than 5% of the aggregate loan commitments included in the portfolio.

[0052] After the loan commitment concentration is determined for each borrower, the industry diversification of the portfolio is determined as illustrated in **FIG. 2C**. More particularly, an industry code identifying the industry occupied by the business or operations for each borrower is determined in step 136 from a list 138 of industry groups and corresponding classification codes, such as provided by S&P. After the industry codes have been identified for each borrower in the portfolio, the number of industries represented in the current portfolio is counted in step 140 to determine whether at least 12 different industries are represented in the current portfolio. If not, other eligible credit facilities in other industries are added to the portfolio, if possible, to meet the industry diversification criteria, subject to the 5% borrower loan commitment concentration criteria described above. If that is not possible, a determination is made that the portfolio is not likely to meet credit rating agency industry diversification criteria.

[0053] Once the industry diversification criteria are satisfied, the loan commitment concentration for each industry is determined in step 148 to ascertain whether the current portfolio meets loan commitment concentration criteria as illustrated in **FIG 2D**. More particularly, the steps, illustrated in **FIG. 2D**, test whether the current portfolio meets S&P industry concentration limits. The database model may also be used to test whether the portfolio is likely to have a Moody's diversity score of at least 25 using Moody's published diversity score model which is also dependent on industry diversification. Initially in step 150 in the illustrative example, the current portfolio is evaluated to determine if the loan commitment concentration is less than 5% for at least four industries. If not, the current portfolio is rebalanced in step 152, subject to the criteria discussed above to attempt to satisfy this industry concentration requirement. If so, the portfolio is further evaluated in step 150 to determine whether the loan commitment

concentration is at least 5%, but less than 8% in at most five industries. If this criteria is not met, the portfolio is rebalanced in step 152 as discussed above. If the criteria is met, the portfolio is further evaluated to determine whether the loan commitment concentration is at least 8%, but less than 12% in at most two industries in step 156. If not, the current loan portfolio is rebalanced in step 152 as discussed above to meet this criteria. Subsequently in step 158, the loan commitment concentration is evaluated to determine if there are any concentrations of at least 12%, but less than 16% in at most one industry. If this criteria is not met, then the portfolio may be rebalanced as discussed above to attempt to meet the criteria. If the criteria is met, the industry concentration further is evaluated to determine whether the loan commitment concentration is less than 16% for all industries represented in the current portfolio in step 160. Once again, if this criteria is not met, the portfolio is rebalanced in step 152, as discussed above. The borrower and industry concentration and diversity standards discussed above are merely exemplary and may be adjusted to reflect current credit rating agency standards and subsequent modifications.

DUE DILIGENCE

[0054] The system in accordance with the present invention may include a comprehensive protocol including: conducting on-site due diligence of each credit facility in a lender's distressed credit facility portfolio; performing a discounted cash flow valuation for each credit facility in the distressed credit facility portfolio; maintaining a current database to include the financial and restructuring progress of each borrower in the distressed credit facility portfolio; developing a capital structure for the SPE based on the information discovered during the due diligence and database creation process; determining collateral value estimates for each borrower; developing a workout strategy for handling workout of a borrower's distressed loans; and analyzing the performance of each asset in the SPE's portfolio. Various models may be utilized depending on the particular credit rating agency or agencies involved in the transaction. It is preferable to process financial data using computer programming, due to the many variables involved.

This information may be organized by way of various commonly available software platforms, such as Microsoft Office 2000.

[0055] As part of the due diligence review, computerized database models or templates, as described below, may be used as a guide to facilitate the quantitative, qualitative and legal evaluation in order to (i) assure the credit rating agencies that full, accurate disclosure has been made, and (ii) efficiently provide the credit rating agencies with concise, but sufficient information regarding each borrower, its financial statements and the borrower's loans to be included in the portfolio (and, perhaps, other debt facilities of the borrower), general pricing parameters for the loans to be included in the portfolio, and other valuation criteria and/or analyses to facilitate the agencies' independent examinations of recovery values (rather than the agencies requiring their own direct examination of the underlying due diligence information and documentation). Each database model may include numerous fields for data, such as borrower financial statement data, principal amounts, interest rates, credit metrics, amortization tables, industry information and cash flow projections.

OVERVIEW OF LOAN DOCUMENTATION

[0056] After the credit facilities are selected for the portfolio and a determination is made that the portfolio meets the borrower and industry diversification and loan commitment concentration criteria as discussed above, the collateral manager processes the documentation as discussed above in connection with step 102 (**FIG. 1**) and performs a due diligence review of the lender's credit facility documentation 172 (**FIG. 3**) and assembles the required information, as will be discussed in more detail below, in a database or template to facilitate review, as discussed above. The database model may include borrower data 176, credit facility/debt descriptions 178, financial statement data 180, and general pricing parameters 182 for each credit facility in the portfolio, as described in detail below in connection with the illustrative example in **FIGS. 6-10J**.

[0057] The general pricing parameters 182 may be determined by the collateral manager, based on the collateral manager's preliminary assessment of a qualitative path of restructuring in order to quantify anticipated cash flow streams and anticipated

recoveries, *e.g.*, estimate the number of months of anticipated current interest payments, estimate the percentage of principal recovery at the end of that number of months, and discount the result by 25% or another commercially reasonable discount percentage, as described below in connection with the illustrative example in **FIGS. 6-11**.

[0058] As described in more detail below, all of this data is then used to calculate valuation criteria in step 174 for valuing each credit facility in the distressed commercial credit facility portfolio. Of course, any suitable spreadsheet or accounting, financial, or database software (*e.g.*, Microsoft Excel, Microsoft Access, *etc.*) may be used to facilitate the input of the data and to perform these calculations more simply or even automatically, as will be readily appreciated by those of ordinary skill in the art.

[0059] In order to calculate the loan valuation for each credit facility in the portfolio, various decision variables may be determined by the collateral manager. These decision variables are described in more detail below. These decision variables may include collateral value estimates 186 for each borrower, a work-out strategy 188 for handling work-out of the borrower's distressed credit facility and work-out parameters 190. In each case, these decision variables are determined in the judgment of the collateral manager based on parameters, such as (i) a sale of the borrower entity as a whole, (ii) an orderly sale or sales of the borrower's assets, (iii) a liquidation of the borrower's assets, (iv) the loans performing to maturity, and/or (v) refinancing all or a portion of the outstanding loans at a discount. This process is repeated for each credit facility in the portfolio.

[0060] A valuation is then calculated for each credit facility in step 192, as described in more detail below in connection with the illustrative example in **FIGS. 16A-16C**. Thereafter, due diligence reports 194 and any necessary or appropriate *ad hoc* reports 196 relating to any borrower or any credit facility may be generated for review and analysis by the collateral manager, lender, credit rating agencies and any insurers in connection with the contemplated securitization. In addition, an aggregation is performed in step 198 using the loan valuations, determined in step 192, in order to develop a capital structure 200 for the SPE, and a securitization model 202. As will be discussed in more

detail below, a securitization model may be used to ensure that the SPE's capital structure, reserve accounts and cash distribution waterfalls, in conjunction with the selection of the underlying collateral of the distressed credit facilities, are configured to emulate the cash flow and recovery characteristics of a securitization of performing credit facilities in order to attain an investment grade rating or ratings for all of the various tranches of debt instruments included in the capital structure above any equity or equity-like securities.

EXEMPLARY LOAN DOCUMENTATION

[0061] FIGS. 4 and 5 illustrate exemplary due diligence loan documentation materials 204 obtained by the collateral manager from the lender for each credit facility in the portfolio in connection with securitization according to the present invention. By way of example and not limitation, this due diligence loan documentation may include for each loan: (1) descriptive material 204, such as an original syndication book, loan approval memoranda, any relevant presentations to the lender, other financial institutions and/or advisors; (2)(a) for publicly traded borrowers, various financial information 205 including all filings, notices and reports of the borrower under U.S. federal securities laws (*e.g.*, Forms 10-K, 10-Q, 8-K, *etc.*) during the borrower's three fiscal years (or such shorter period as the borrower has been publicly traded) preceding the proposed securitization, for the immediately preceding (or last) 12 months (the "LTM"), and for the most recent year-to-date interim period; and (b) for borrowers that are not publicly traded, financial information, such as audited financial statements for the three fiscal years preceding the proposed securitization (or such shorter period as the borrower has been in existence), for the LTM, and for the most recent year-to-date interim period; and (3) various legal documents 206, including the original loan documents, and all amendments, restatements, waivers, and forbearance agreements relating to the credit facility.

[0062] FIG. 5 illustrates exemplary additional due diligence loan documentation 207-210, which may include, without limitation, compliance certificates 207 (including, without limitation, borrowing base calculations and covenant compliance calculations);

independent appraisal reports step 208 regarding the borrower and/or the borrower's assets; various additional information 209 (for example, the composition of the loan syndicate for a particular credit facility (sometimes referred to herein as a "bank group"); the aggregate amount of loan commitments for all members of the applicable bank group including both funded and undrawn amounts (collectively, the "Global Commitment"); current credit memoranda including discussions of the borrower and any problems the borrower may have, as well as the bank group and its related obligations); and a correspondence file 210 including, without limitation, at least six months of correspondence among, for example, the bank group, the lender's advisors, and the borrower's advisors.

[0063] The collateral manager uses the above mentioned information to assess the status of any restructuring negotiations, including potential debt forgiveness, anticipated changes in legal documentation of the credit facility, and upcoming asset sales in order to price the credit facility properly. The information discussed above is intended to provide the collateral manager with a snapshot of what transpired historically, and also to enable the collateral manager to anticipate likely future events and the potential effects on cash flow and recovery for a particular borrower.

DATABASE MODEL - BORROWER DATA

[0064] FIG. 6 illustrates an exemplary database model for organizing the borrower data 176 (FIG. 3). More particularly, the database model or template may be developed with various fields, as discussed below, to organize the various credit facility documentation 172 (FIG. 3). As noted above, suitable software applications, such as commonly available accounting or financial databases and/or spreadsheets, may be used to set up the various fields in the database. By way of example and not limitation, such a database model for borrower data 176 for a given credit facility may include: a field 211 (FIG. 6) for the name(s) of the borrower; and a field 212 for a unique borrower identification number that may be assigned by the collateral manager simply for reference purposes. Another field 214 may be provided for an identification of the market, if any, where any equity securities of the borrower are publicly traded. This field 214 optionally may be

implemented with a conventional Windows scroll-bar in a spreadsheet, allowing for user-selection from among a list of available markets. A field 215 may also be provided with the applicable stock symbol or symbols for each borrower that is publicly traded. A field 216 may also be included to provide an indication of whether the borrower has any publicly traded debt securities. The database model may further include a field 217 for the Moody's industry code associated with the borrower's business and a field 218 for the S&P industry code. A field 220 may be provided to include a description of the borrower's business operations and a field 222 for a description of the borrower's business model. The database model may also include a field 224 for a statement of the geographical scope of the borrower's business and a field 226 for a discussion of the causes of the borrower's financial weakness or distress in the view of the collateral manager. A field 228 may also be provided to include a discussion of the factors driving performance of the borrower, including, for example, involvement of a financial advisor. A field 230 may be used for an identification of the loan documents governing the credit facility, an identification of all financial institutions comprising the syndicate or bank group and their corresponding participation percentages, and an indication of the vote(s) required to amend or waive various provisions of the loan documents. A field 232 may also be provided to include an explanation of the risk factors and/or exposures applicable to the borrower or the borrower's industry in the view of the collateral manager. A field 234 may be provided to include an identification of any equity sponsorship of the borrower and sources of subordinated debt financing and, finally, a field 236 representing any additional information may be included in the database model for each credit facility.

DATABASE MODEL - LOAN INFORMATION

[0065] Each credit facility in the distressed credit facility portfolio may include one or more loans or facilities of various types, including, without limitation, term loans, revolving loans (sometimes referred to as "revolvers"), letter of credit facilities, acquisition financing facilities, and capital expenditure facilities. The borrower may also have other debt facilities not included as part of credit facilities described above, such as public debt financing or a separate receivables facility. Information regarding such credit

and debt facilities may be included in a database model along with the borrower information discussed above. More specifically, as shown in **FIG. 7A** in the illustrative example, the database model for loan information may be configured with various fields to organize the loan information. For example, the loan database model may include for each loan in a credit facility: a field 238 for the name of the loan and an identification number for the loan (assigned by the collateral manager); a field 240 for the name of the obligor(s) on the loan; a field 242 for an indication of the currency (or currencies) in which the loan is denominated (i.e. U.S. dollars); a field 244 for an indication of the priority of the loan to the borrower and for an indication of the secured or unsecured status of the loan (e.g., debtor-in-possession (“DIP”) loan, senior secured, senior unsecured, subordinated secured, or subordinated unsecured); a field 246 for an identification of whether the loan is a term loan or a revolver or some other type of facility; a field 248 for the original date of the loan; a field 250 for an indication of the placement of the loan (e.g., broadly syndicated, middle market, or commercial); a field 252 for a Boolean (i.e., yes-or-no) indication of whether the loan facility is small (i.e., defined as less than \$50,000,000). The loan database model may further include a field 254 for an identification of the current loan or credit agreement and/or amendment(s) thereto governing the loan (determined in step 230, **FIG. 6**); a field 256 for the date of the latest amendment affecting the loan; a field 258 for an identification of the number of the latest forbearance made by the lender in connection with the loan; and a field 260 for an indication of the date of that forbearance; and a field 262 for the expiration date of the latest forbearance.

[0066] Referring to **FIG. 7B** in the illustrative example, the loan database model may further include a field 264 for the dollar amount of the original Global Commitment; a field 266 for an identification of any guarantor(s) on the loan; a field 268 for an indication of the degree of support that the borrower may be expected to receive from the guarantor(s) if necessary (e.g., do the guarantors have the ability to pay the loan if the guarantee is called, or are the guarantors entities who themselves have high quality credit ratings); a field 270 for a description of the collateral securing the loan (e.g., all assets,

contractual rate for the loan as the sum of the cash interest rate and PIK rate (if any); and a field 301 for an indication of the current cash payment rate. The loan database model may also include information about the terms of the loan relating to repayment of principal, such as a field 302, for an indication of the original final maturity date of the loan; a field 304 for any amended final maturity date of the loan (without regard to any subsequent default or acceleration); a field 306 for an indication of the borrower's principal payment status (*e.g.*, current, in default, or deferred); and a field 307 for the date or dates of any default(s) on any required principal payments. The loan database model may further include a field 308 for specifying the date on which loan balances were obtained; a field 310 for the dollar amount of the aggregate commitment of all members of a bank group to the borrower (the "Global Commitment"); a field 311 for the dollar amount of aggregate outstanding principal that has been funded by all members of the bank group, including the lender (the "Global Funded Principal"); a field 312 for the percentage of the Global Commitment held by the lender; a field 313 for the percentage of the Global Commitment that the lender has offered to sell in connection with the proposed securitization; a field 314 which calculates the dollar amount of the percentage of the Global Commitment held by the lender as the product of fields 310 and 312 and stores the result as the "Lender's Commitment"; a field 315 which calculates the dollar amount of the percentage of the Global Funded Principal held by the lender as the product of fields 311 and 312 and stores the result as the "Lender's Funded Principal"; a field 316 which calculates the dollar amount of the percentage of the Lender's Commitment offered for sale as the product of fields 314 and 313; and a field 317 which calculates the dollar amount of the percentage of the Lender's Funded Principal offered for sale as the product of fields 315 and 313 and stores the result as the "Funded Principal Offered"; and a field 318 for any comments or other miscellaneous information that the collateral manager considers appropriate to clarify other information included in the loan template.

[0069] Turning to FIG. 8 in the illustrative example, the loan database model may further include various fields regarding the contractual amortization of each loan. For

example, a field 320 may be provided for a schedule of the contractual amortization for each loan. Additional fields 322, 324, 326, and 328 may be provided for various other information regarding the amortization schedule. Specifically, the loan database model may include: a field 322 for the amortization start date; a field 324 for the amount of each global scheduled principal payment in the amortization schedule; a field 326 for an indication of the amortization frequency (*e.g.*, monthly, quarterly, semi-annually, or annually); and a field 328 for the number of installments or payments in the scheduled amortization. The information regarding the loan contractual amortizations is repeated for each loan and entered into the fields 320-328.

[0070] Turning to **FIG. 9** in the illustrative example, the loan database model may include various fields regarding the bank group (which could be one or more financial institutions) for each loan. More particularly, for each loan, the loan database model may include a field 331 for a specification of the bank group or list of financial institutions participating in each loan; a field 332 for an indication of the first member of the bank group which serves as first agent or co-agent for the credit facility (the “First Agent Bank”); a field 333 for an indication of another or second member of the bank group which serves as agent or co-agent for the credit facility (the “Second Agent Bank”); and a field 334 for the “as of” date of any due diligence information provided regarding the bank group.

[0071] The loan database model may also include fields 336, 338, and 340 for each financial institution in the bank group. In particular, for each financial institution in the bank group the following fields may be provided: a field 336 for the name of that institution; a field 338 for the dollar amount of the commitment made to the borrower by that institution in connection with the loan; and a field 340 for the percentage of the Global Commitment extended by that financial institution. Either or both of the fields 338 and 340 may be used as a measure of the relative contributions of each member of the bank group to the Global Commitment (*i.e.*, each institution’s commitment may be expressed as a dollar amount or as a percentage). The financial institution data for each financial institution in a bank group is repeated and entered into fields 332-340.

fraction whose numerator is Class A Revolving Notes commitment and whose denominator is total Class A Notes commitment. In step 1150 in the illustrated example, a determination is made of the tentative total SPE assets as the sum of the SPE asset subtotal and the Class A-3 Revolving Reserve Account amount. In step 1152, a determination is made whether the tentative total amount of SPE assets is equal to the sum of the tentative funded Class A Revolving Notes, the A-3 Notes, the Class A-3 Revolving Reserve Account, the Class B Notes, the Class C Notes, and the tentative SPE equity. If not, the process described above is repeated and another iteration of the calculations is performed.

[00131] **FIG. 22** depicts an exemplary spreadsheet representation of an SPE capital structure developed by the process illustrated in **FIGS. 21A-21D**. The capital structure includes “SOURCES OF FUNDS” shown on the right hand side of **FIG. 22**, “USES OF FUNDS” shown on the left hand side of **FIG. 22**, and other information regarding the SPE capital structure developed in accordance with the principals of the present invention. As shown, the SPE capital structure may include among the sources of funds, a plurality of tranches of debt instruments (*e.g.*, Class A-1/A-2 Revolving Notes, A-3 (term) Notes, Class B Notes, and Class C (discount) Notes), as well as an equity account. When a securitization in accordance with the principles of the present invention is closed, these debt instruments are issued to investors in exchange for funded capital as shown in column F on **FIG. 22** (and to the lender as part of the purchase price for the portfolio of distressed credit facilities), and, in the case of the Class A-1/A-2 Revolving Notes, unfunded commitments to contribute future capital, as shown in column G. Aggregate unfunded principal appears in cell B21 (*i.e.*, column B, row 21) and is computed as the difference between aggregate loan commitments (cell B2) and aggregate funded principal (cell B3). This aggregate unfunded principal (\$150 million in the illustrated example) is to be funded from the Unfunded Revolver Discount Account (URDA) and also jointly from the Class A Revolving Notes availability and Class A Revolving Reserve Account, as shown in cells B22 and B24 of **FIG. 22**.

[00132] The simultaneous equations which generate the Class A Revolving Reserve Account amount, referred to above in connection with step 1148 of **FIG. 21D**, represent constraints imposed on the capital structure illustrated in the spreadsheet of **FIG. 22**. More particularly, the capital structure must be established such that the value in cell I22 is zero (subject to small rounding discrepancies, for example, 0.03% is the value in cell I22 in the illustrative example). This condition, in turn, requires that the values in cells I4 (the percentage of the total Class A Notes represented by Class A-1/A-2 Revolving Notes) and I18 (the percentage of the total Class A Notes commitment represented by Class A-1/A-2 Revolving Notes availability) are equal (subject to small rounding discrepancies, for example, a difference of 0.03% in the illustrative example) in order to keep Class A Revolving Notes and Class A Term Notes balanced in the face of future funding requirements.

DEFAULT/RECOVERY SCENARIOS

[00133] The process 1096 (**FIG. 18**) for specifying default/recovery scenarios is now described in connection with the illustrative example in **FIGS. 23A-23B**. As shown in the illustrative example in **FIG. 23A**, calculations are made in step 1154 to determine: the amount of funded revolving loans; the proportion of the total loan commitments in the distressed credit facility portfolio represented by revolving loan commitments; the proportion of the revolving loan commitments in the distressed credit facility portfolio represented by funded revolvers; and the portfolio LIBOR interest spread. The amount of funded revolving loans is calculated as the difference between the aggregate revolving loan commitments and the aggregate unfunded revolving commitment amount. The revolving loan commitment percentage is calculated as the ratio of the revolving loan commitments to the total commitments expressed as a percentage; and the funded revolver (i.e. revolving loan) percentage is computed as the ratio of the funded revolvers to the revolving loan commitments, again expressed as a percentage. The portfolio LIBOR spread is calculated simply as the difference between the weighted average contractual interest rate and the LIBOR rate. A series of quarterly cash flow dates

